Marshalls Energy Company

With the demand for payment from Mobil for all the fuel at one time, this meant that MEC could not import any more diesel fuel before it had paid fully for the existing fuel stocks. So to keep the lights on in Majuro, the lucrative business of fuel sales to fishing vessels was suspended to conserve fuel. MEC could no longer subsidize its true generating costs through these sales.

Q: What were the causes of MEC's financial hardship and losses that started in the 2004-05 period?

The major factors causing the MEC financial hardships are twofold:

• The unprecedented rise in the world diesel fuel price from $20-25 per barrel in 2003 to $70 per barrel in the 2004-05 period, which equates to approximately a $1 per gallon increase. The Majuro power plant consumes 450,000 gallons per month so the increase in operating costs was an additional $450,000 per month for the cost of fuel.

The increase in world fuel price affected power utilities throughout the world and even more so the smaller utilities in the Pacific, Caribbean and elsewhere. Even the larger utilities in the Pacific region such as Fiji, Guam and Saipan suffered heavy financial losses, and exhausted their capital reserves and experienced power rationing because of the inability to purchase fuel. Some of the utilities had fuel-based tariff systems and cash reserves. But when some utilities had to increase tariffs by 300 percent, customers could not afford the increase and the cash reserves of the utilities depleted rapidly.

• The breakdown in negotiations with MEC's fuel supplier, ExxonMobil, was the second major factor. The result of this was that ExxonMobil demanded payment all at once for $7.8 million for the fuel in MEC's tanks, which was delivered in September 2005. ExxonMobil had been MEC's fuel supplier since 1993 and the fuel was paid for monthly, based on the previous month's sales and usage. This method of payment had been in place since 1986 and was also used with the previous supplier, Shell Pacific Islands. Mobil would "top up" MEC's tanks, which meant that if the supplier needed fuel for elsewhere it could take fuel from the MEC tanks. ExxonMobil regularly took fuel from the MEC tanks for the Federated States of Micronesia, especially when the Guam bulk fuel storage plant and dock were out of action because of hurricane damage, an earthquake and a major fire. With the demand for payment for all the fuel at one time, this meant that MEC could not import any more diesel fuel before it had paid fully for the existing fuel stocks. So to keep the lights on in Majuro, the lucrative business of fuel sales to fishing vessels was suspended to conserve fuel. MEC could no longer subsidize its true generating costs through these sales.

Q: In 2005, MEC applied to the Bank of Guam for a $5 million loan. What did the bank approve for MEC at that time?

In August 2005, MEC management recommended to the Board that in order to pay off the debt to Mobil and resume fuel sales, thereby avoiding a financial loss for the year, the electricity tariffs would need to increase and a $5 million loan, to pay off the money owed to Mobil over a five-year period, would be needed. This would then allow the resumption of fuel sales to assist in paying back the loan.

In September 2005, responsibility for negotiating the loan was assigned to the Chief Secretary, also a member of the MEC Board of Directors. In January 2006, MEC was granted a loan of $2 million with a letter of credit (LC) for $3 million dollars on a 90-day repayment period. The delay in receiving the loan meant that profitable fuel sales were again suspended for several months with the subsequent loss of badly needed revenue.

Q: What would this $5 million loan have done for MEC if it had been approved and why was the letter of credit/loan combination not adequate to stabilize MEC's financial situation?

The $2 million loan and $3 million letter of credit as awarded by the bank was not sufficient to retire the ExxonMobil debt and purchase sufficient quantities of fuel. The Board and management acknowledged the need to secure additional alternative financing to put MEC back on track.

The Chief Secretary negotiated a settlement with ExxonMobil for the $5.7 million outstanding balance owed at 18 percent interest. ExxonMobil insisted the 18 percent interest be applied as negotiated in 1986 by the RMI Attorney General and MEC.

Q: MEC's financial situation in 2007 has deteriorated significantly from when it applied for a $5 million loan from BOG in late 2005. Why does MEC believe that BOG would support a $12 million loan now but would not provide a $5 million loan in 2005?

MEC does not know why the bank did not approve the loan request in 2005. Other than supplying financial information and projections, MEC Board and management were not involved in the negotiations; the first loan was negotiated by the Chief Secretary. In contrast, the second loan was negotiated by the Special Committee appointed by Cabinet, the MEC chairman and management. Had the first loan been provided as requested, MEC would not have incurred the problems or have needed to make a payment agreement with ExxonMobil, which resulted in the 18 percent interest charge.

One possibility why the bank changed its position from 2005 to now and lent MEC the $12 million is the bank realized the projections originally made by MEC regarding the reduction in receivables and increase in revenue were correct. Additionally, the independent review of MEC carried out by Nelson and Associates clearly showed that the majority of the problems were not caused by bad fiscal management (as was being claimed independently by some people outside of MEC), and that MEC was improving its cash flow and reducing line losses. Additionally the bank saw MEC was already successfully paying three times the amount that MEC would need to pay for the BOG loan without missing any payments and still providing uninterrupted power to the community.

Q: What are the specifics of MEC's debt/loan situation now?

MEC currently owes $3.2 million to Mobil, $1.2 million to the BOG, $3 million due on the letter of credit to its fuel supplier, and $3.4 million to SK for the balance due on the current fuel shipment. The money borrowed and owed back to the RMI government is currently being offset against the government's monthly electric bills and repayment is scheduled to retire all the debt based upon actual cash flow.

Q: What is the so-called Nelson report?

In September 2006 the Chief Secretary informed the MEC Board that he had secured Department of Interior funding to retain an independent consultant to carry out a "Strategic Financial Plan and Performance Audit Review" of MEC and MEC management to look at the possibility of splitting up the MEC operations and privatizing some of these operations. The services of Nelson & Associates were retained and the consultants where Robert E. Nelson and Michael A. Conduff. The consultants carried out their investigation from October to December 2006 and their report was submitted to the RMI and MEC in January, 2007. The report was circulated to Nitijela in the January session and some parts of the report have been printed in the Marshall Islands Journal. The main items identified for the financial problems facing MEC were: ExxonMobil, inadequate tariffs, lack of authorization for management to raise tariffs, lack of reserve fund, and generation and line losses.

Q: Why didn't MEC develop a reserve fund?

From 1982 until 1986, the power plant was operated by IPSECO (a management company); billing and collections were the responsibility of the Secretary of Finance; and distribution was the responsibility of Public Works. In 1984 the Marshalls Energy Company, Inc. was formed to act as a joint venture with IPSECO responsible for the management and operation of the Majuro power plant.

In February 1986, the President and Cabinet discontinued the management contract with IPSECO and appointed Billy Roberts (the former Electrical Engineer/Superintendent), as the General Manager

message to its customers

of MEC. Effective March 1, 1986, MEC became responsible for billings, collections and distribution of electrical power on Majuro.

The mandate set by the President and Cabinet was to develop a diesel fuel sales market and provide reliable electricity at a minimum cost to attract development and make power available to all Marshallese citizens residing in Majuro. To allow time for MEC to install a billing system, stabilize the power supply and increase tariffs, RMI was to continue supplying a subsidy until MEC was at least breaking even.

The subsidy in 1986 was $1.7 million. This amount reduced annually to $400,000 in 1992. However the first subsidy received in 1986 was used to pay off an outstanding $1.4 million debt accrued by IPSECO to Shell Guam for fuel purchases it had not paid for.

In September 1993, the government's annual subsidy to MEC ended at MEC's request, because MEC was now profitable.

In June 1993, the government's management contract with PMSC for the operation and maintenance of MWSC was ended and the MEC general manager was appointed as the MWSC manager. The MEC general manager accepted the position on condition that the MWSC annual subsidy would continue and the RMI government would pay for the government's actual water usage.

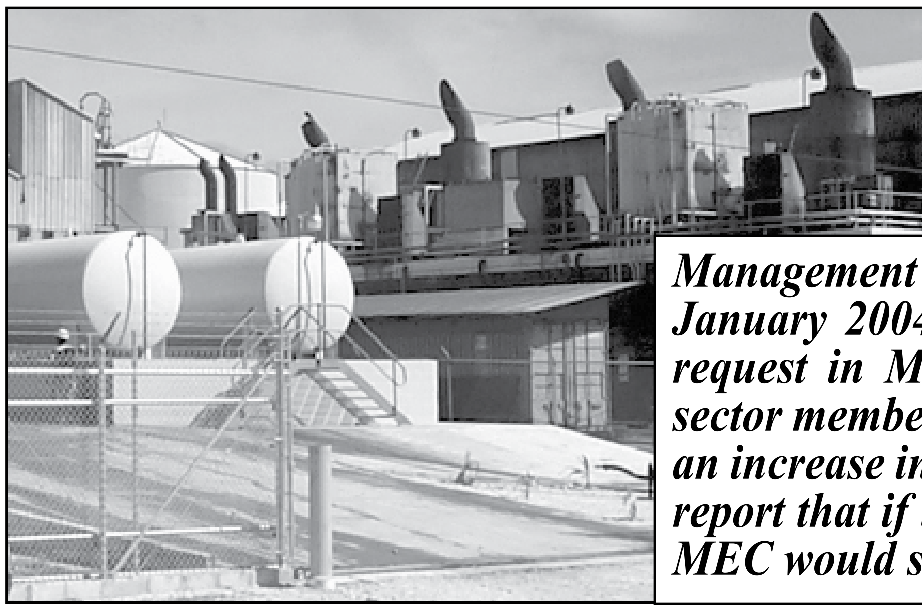
In November 1993, MEC was given the responsibility for operating the Jaluit power plant and to increase the reliability and efficiency of the power supply in Jaluit. MEC did this by improving the power plant and upgrading the power system. From 1993 until 2005 MEC received no subsidy for Jaluit for this work. To maintain power in Jaluit, MEC subsidized the operation at $220,000 per year from fuel and LPG sales in Majuro. MWSC continued to receive a subsidy, which was less than the actual water bills for the RMI government annual accounts.

MWSC was subsidized approximately $75,000 annually by unpaid electricity charges so MWSC could repay a $540,000 debt to MISSA inherited from the management company PMSC. MEC and MWSC Management attempted to have the penalties and interest removed but MISSA refused demanding full payment with interest charges.

In spite of these cross-subsidies, MEC continued to make a small profit up until 2003 when the fuel crisis started. As documented in the Nelson report, MEC has provided $7 million in subsidies, which allowed MEC to keep its electricity tariffs low and also increased the RMI gross domestic product by $35 million over the same 15-year period.

Revenue from fuel sales has continually subsidized Jaluit, MWSC, and streetlights and, beginning in 2004, the Wotje power system.

Additional projects were also undertaken including the replacement of the old aluminum high voltage cable, introduction of three new underground feeders from the hospital to downtown (F3 to the hospital, TF1 from the bowling alley to demon town and from CMI to MIC back-road).



Management requested an increase in January 2004. The Board met on the request in May 2004 and the private sector members rejected the request for an increase in spite of the management report that if tariffs were not increased MEC would suffer a financial loss.

Laura village was energized and numerous branch line cables installed between the airport and Laura, allowing customers living there to be connected to Majuro power without being charged the full cost of providing power.

Q: Why was power plant #2 built in 1999, and what impact did this have on MEC's ability to have a reserve fund? If MEC had not provided the contingency of the Deutz engines what would the situation have been and/or be for Majuro power generation?

In 1996, the Board of MEC approved the management's request for a new power plant. Based on projections of power use in Majuro, management estimated that unless this action was taken Majuro would suffer power rationing by 1998/99 due to load growth. In 1997, MEC became the first power utility outside of the US to successfully apply for and receive a loan via the Rural Utility Service (RUS) for $12.5 million. A full, in-depth study was carried out by the RUS engineering and accounting departments and the only condition of the loan being approved was that tariffs where to increase by one cent per KWH to 11 cents lifeline, 12 cents residential and 16 cents Government/Commercial. The tariff condition imposed by the RUS was based on full cost recovery and does not take into consideration income from non-power generated sources such as fuel sales.

Q: From what year to what year did MEC require board and then Cabinet approval for a rate increase? When did it change, and how does the current procedure for tariff changes work?

From 1986 until January 2005 when the current tariff template came into force, all requests to change tariff rates needed Board and then Cabinet approval. Twice in the history of management's requests through the board there have been delays. These occurred once in 1998 and again in 2004. The latter delay is cited in the Nelson report: Management requested an increase in January 2004. The Board met on the request in May 2004 and the *private sector* members rejected the request for an increase in spite of the management report that if tariffs were not increased MEC would suffer a financial loss. The Board later approved the tariff increase request in November 2004 and the Cabinet approved the Board recommendation for the increase to take effect on January 1, 2005.

In July 2005 management requested the adoption of a tariff template to be handled by management based on world fuel prices, which the Board approved and Cabinet approved in September 2005, resulting in amended rates in November 2005. The tariff template allows MEC to change the tariffs based on the world price of fuel without needing Cabinet approval. This is because all the possible new tariff rates are listed in the template as they would be if the price of fuel rose or fell. Independent verification of the rise or fall of prices is supplied to the Board and media to justify an increase or a decrease in tariffs.

Q: Are there certain operations of MEC that require ongoing RMI government subsidy? If yes, what are they and why?

The Board has mandated that all of MEC's operations shall operate in the black. In the case of Jaluit and Wotje this will mean that a government subsidy will be needed. If a subsidy is not forthcoming MEC will remove itself from the operations of those plants.

The other option (for Jaluit and Wotje) is to charge the correct tariffs, which would be around 51 cents per kilowatt hour (currently it is 21 cents); this is the same with KAJUR. The reason is that the customer base is too small to generate sufficient revenue for cost recovery. But charging 51 cents per KWH would have the same effect as closing the plants because customer wages and incomes are still relatively low and have remained stagnant over the past 10 years so people and businesses could not afford electricity at this cost.

In 2006, for the first time, the government provided subsidies for Jaluit and Wotje power operations of $210,000 each. In 2007, Jaluit and Wotje received a combined $420,000 subsidy.

The same subsidy requirement applies to the solar programs now being implemented by MEC. If solar cannot self-fund through tariffs a subsidy will be required or MEC will have to close the operations. In 2004, the government provided a subsidy of $173,994 for the Namdrik solar project, and in 2005, the government provided a subsidy of $400,000 for the Mejit and continuing solar projects. Both of these are part of the Solar Fund under the Ministry of R&D/MEC joint venture.

Q: What is the status of the various investment or management proposals?

The Special Committee appointed by Cabinet looked at all the options available, including the three unsolicited management proposals, and recommendations made in the Nelson report. The three proposals from SK Networks (SKN), Pacific International Inc. and TEMES were all rejected. The Special Committee believed the best option was for MEC itself to refinance the high interest debts, which resulted in the request to MISSA and then to the Bank of Guam. The irony of the situation is that the net result of the three proposals would have meant that MEC would lose revenue from fuel sales and that many Marshallese workers would be replaced by foreign workers in the power plant. The Special Committee's approach focused on the cost-savings to MEC by ensuring expensive management fees would not need to be paid to outside companies and that the cost of fuel for the power plant charged to MEC would not increase to avoid customers having to pay higher tariffs for electricity. The proposals from the two other companies called for MEC's high interest loans to be refinanced, with MEC having to service the loans, while losing the revenue from fuel sales and having to pay a management fee.

The only reason the Special Committee continued dialogue with SKN, whose proposal was also unsolicited in spite of rumors to the contrary, is because SKN is the existing contracted fuel supplier to MEC and SKN's proposal was the only one that was proposing to invest money ($12 million) for the management and operation of the tank farm. MEC could use these funds to pay off MEC's debts and would not be required to repay the funds to SKN. This was a tempting offer. However, negotiations failed because of the terms and conditions of SKN's proposal with regard to ownership and tax concessions.

Next week:
MEC's plans for the future